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July 31, 2008

Ms. Anne Stausboll  
Interim Chief Investment Officer  
California Public Employees' Retirement System  
400 Q Street  
Sacramento, CA 95814

Re: Securities Lending Collateral Investment Management

Dear Anne:

Wilshire has conducted a review of the internal securities lending collateral management team's personnel, investment process, and resources. This review was conducted as part of Wilshire's contractual requirement to periodically review all of the internal asset management functions. In general, we found that the team manages the portfolio in an effective, risk controlled manner and has state of the art systems to assist in monitoring and managing the portfolio.

As part of our review, we met with Staff members involved with the management and trading of the collateral backing the securities lending program. We discussed the strategy for each portfolio, how research is conducted, what risk controls are in place, how the portfolio is traded and how feedback and input is provided at each step of the investment process.

In short, we believe the investment approach is appropriate for the collateral portfolios. Similar to the rest of the Internal Fixed Income program, Staff is aware of and appropriately manages the risks faced by the portfolios. Staff, though nearing capacity limits, has sufficient resources at its disposal; and the custom-designed (by an external third-party) portfolio management and trading platform is high quality and helps to achieve the program's goals. We believe that Staff is using high quality technology systems that are appropriate for the team's operations. As CalPERS' securities lending program continue to grow, additional staff members are likely to be needed.

Wilshire views the overall investment approach quite favorably. Staff's desired yield advantage, although not an "all weather" strategy, tends to perform very well across a market cycle. The strategy is likely to underperform when credit and structured spreads

widen, an effect which has been particularly acute during the last 12 months. As a result of this review, we continue to be confident in the ability of CalPERS' Staff to effectively manage the collateral for the securities lending program.

### Securities Lending Collateral Management Overview

The securities lending collateral is managed by the same team overseeing the limited duration portfolio and is managed in accordance with the CalPERS' Global Fixed Income Policy – Dollar Denominated Fixed Income Limited Duration Investment Policy. As such, this portfolio is invested in structured securities with short maturities, which are generally rated AAA or A1/P1. Additionally, stress testing is performed on the structured securities in order to understand and appropriately manage how changes in interest rates will affect the price of the securities.

It is important to remember that the securities lending program must take on investment risk within the collateral investment pool in order to earn a spread on each loan. Essentially, the collateral investment pool must produce a return in excess of the Fed Funds rate. As discussed earlier, Wilshire believes it is appropriate to take on the incremental risk necessary to produce returns over and above the Fed Funds rate of return.

As the short term fixed income markets have been buffeted by high levels of volatility and a lack of liquidity, the collateral portfolio produced an *unrealized* loss of \$354 million as of June 30<sup>th</sup>, 2008. It is important to note that Fixed Income Staff believes these mark-to-market valuations are temporary and the collateral portfolio is invested fully in securities that are 'money-good' (expected to pay full par value at maturity, without default). The securities are of high quality and are expected to mature at par over the next 1 to 2 years.

The makeup of the portfolio for both HQL and SDF are shown below, all amounts are in thousands. As mentioned earlier, the collateral portfolio is managed in accordance with the guidelines established for the limited duration funds.

HQL Holdings by Sector (Including STIF Holdings) As of 7/17/2008										
	CMBS	Autos (Retail and Lease)	Autos Dealer Floorplan	Credit Cards	Student Loans	Equipment	Home Eq. (Subprime, Sec Lien, HELOC)	Agency	STIF	Total CMBS and ABS
Total	\$1,285,545	\$1,140,042	\$772,200	\$5,034,701	\$3,581,187	\$255,470	\$2,452,719	\$269,486	\$527,947	\$15,319,297
Percentage	8.39%	7.44%	5.04%	32.87%	23.38%	1.67%	16.01%	1.76%	3.45%	100.00%

SDF Holdings by Sector (Including STIF and ABL Holdings) As of 7/17/2008											
	CMBS	Autos (Retail and Lease)	Autos Dealer Floorplan	Credit Cards	Student Loans	Auto Rental Fleet	Home Eq. (Subprime, Sec Lien, HELOC)	Other	STIF	ABL	Total CMBS and ABS
Total	\$155,065	\$158,550	\$40,000	\$122,826	\$30,000	\$56,000	\$843,384	\$40,835	\$495,689	\$305,146	\$2,247,495
Percentage	6.90%	7.05%	1.78%	5.47%	1.33%	2.49%	37.53%	1.82%	22.06%	13.58%	100.00%

## Risk Factors

The two primary risks of investing in fixed income securities are well known: interest rate risk and default risk. Wilshire believes that Staff is monitoring and managing these risks appropriately. The duration of the securities lending collateral portfolio relatively short, ameliorating much of the interest rate risk. Default risk is managed by limitations on the quality of any issue in the total portfolio. Default risk cannot be eliminated without forgoing the potential return of securitized bonds and investing solely in treasury securities, and academic studies clearly illustrate that the increased yield from slightly more risky securities over a market cycle fully compensates for any normal level of default risk. Staff has demonstrated the ability to monitor and appropriately manage these risks in the portfolio.

As with the other internally managed fixed income programs, there are, however, two risks that are CalPERS-specific which relate to both the total Fixed Income program and the collateral management program. First, CalPERS has invested in systems and technology to provide the fixed income team with state of the art tools. These systems more than adequately address the three primary purposes necessary for managing a fixed income portfolio: data management, data manipulation, and use of the data within the fixed income department. However, this should not be viewed as a one-time investment. These tools and systems need to be maintained and upgraded as necessary so that the team does not face a competitive disadvantage versus other investors. To date, this has not been an issue and Staff continues to receive on-going upgrades to their toolsets.

Second, CalPERS, as a governmental organization, faces some organizational risks that for-profit enterprises do not face. For example, non-governmental organizations can induce key employees to stay with the firm long-term by offering ownership in the enterprise. CalPERS cannot match this retention incentive and is more at-risk for losing intellectual capital than a for-profit enterprise would be. This is an ongoing risk for the entire CalPERS organization, and has been discussed previously in our reviews of the other investment teams within CalPERS.

## Conclusion

In brief, we believe that the collateral management team has demonstrated the ability to both effectively and efficiently manage the portfolio. The investment philosophy is

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appropriate to CalPERS' needs and sufficient risk controls are present to mitigate many of the risks of managing fixed income portfolios.

Wilshire's score on this strategy of 76% or 227 out of 300 possible points reflects the strong team and clear success demonstrated at managing the portfolio as charged. The main reasons for a less-than-perfect score overall are largely due to organizational-level issues such as senior turnover and lack of long-term retention incentives rather than issues specific to the fixed income group. However, as the size of the portfolio grows, additional research staff would help sort through the increasingly complex structured products in the marketplace. This additional staff would also help reduce key person risk associated with the management of the securities lending collateral pool.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

A handwritten signature in black ink, appearing to read "Ann Jinn". The signature is fluid and cursive, with the first name "Ann" and last name "Jinn" clearly distinguishable.A handwritten signature in black ink, appearing to read "T. B.". The signature is more stylized and less legible than the one on the left, with a prominent horizontal stroke.

Strategy Evaluation: CalPERS Securities Lending Collateral Investment Program

**Organization (0-100)**

**SCORE:**

**COMMENTS:**

Ownership/Incentives (0-30)

Direct Ownership/Phantom Stock  
Profit Sharing  
Performance Bonus  
Depth of Incentives

Employees receive performance bonus only. Bonus is driven by multiple factors, some geared around the investment performance generated by the fixed income team but others related to total fund performance. Obviously, no equity ownership is available for employees.

Score: 5

Team (0-25)

Communication  
Role of Manager, Research, and Operations  
Longevity of Team

Team currently is appropriate given size of operation and portfolio, but nearing capacity limits of the current team size. Additional staffing would reduce the key-person risk and allow Staff to focus on more value-added opportunities. The team members have back-ups from others on the team. Communication links are informal and proximity of team members is close, adding to the team's ability to communicate quickly.

Score: 10

Quality of Key Professionals (0-15)

Experience  
Quality of Leadership  
Quality of Education

Education, experience and technical skill set of the portfolio manager are exceptionally good, by any standard. Understands risks and issues to be monitored or resolved regarding strategy. Appropriately concerned about process, reporting, and monitoring.

Score: 15

Turnover of Senior Professionals (0-15)

Low (<10%), Medium (<20%), High (>20%)

Staff turnover for CalPERS (as an organization) is high at both the senior and junior levels, including the departure of 3 CIOs and the SIO for Global Equities in the last several years. Lack of long-term retention incentives lead some staff to consider the organization as a "stepping stone" to better compensation in similar positions elsewhere.

Score: 10

Commitment to Improvement (0-15)

Clear Mission  
Re-investment  
Process Enhance

Strategies have clear mission and objectives. Resources are excellent and currently sufficient for the current tasks assigned to team; however, additional staff could be needed as the securities lending program expands.

Score: 12

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### Philosophy/Process (0-100)

#### SCORE:

#### COMMENTS:

Market Anomaly/Inefficiency (0-40)

Permanent or Temporary

Clear Identification

Where and How Add Value

Empirical or Academic Evidence to Support

Score: 35

The portfolio manager actively manages the portfolio in an attempt to outperform primarily through issue selection in the structured products sector.

Value has been added by focusing on maintaining a yield advantage in the sector. Yield advantage strategies are not “all weather” strategies – the volatility seen in the last twelve months is ample evidence of this – but the consistent additional yield in the portfolio versus the benchmark compounds to the advantage of CalPERS over longer time periods. High score given as the yield advantage approach is appropriate and consistently applied.

Information (0-15)

Unique Sources, Unique Processing

Score: 10

Information sources are primarily external, which is appropriate given the size of Staff relative to the size of the market. In the case of structured products, the underlying securities are analyzed at a granular level. Staff also has frequent contact with outside managers to gain information.

High score given, but this score could improve with the addition of staff members to expand Staff’s ability to internally research securities.

Buy/Sell Discipline (0-15)

Disciplined/Structured Process

Quantitative and Qualitative Inputs

Score: 15

Buy/sell discipline based on relative value of securities. If Staff has an opportunity to “upgrade” one of the holdings in the portfolio, a trade will be initiated by the appropriate sector specialist, who has intimate knowledge of his/her sector.

Portfolio Construction (0-15)

Benchmark Orientation

Risk Controls

Ongoing Monitoring

Score: 15

Portfolio construction techniques and monitoring are very good with industry-leading software. The Strategy has the appropriate policies and procedures on a documented basis in place and a “checklist system” to ensure compliance.

Quality Control (0-15)

Return Dispersion

Performance Attribution

Performance Consistency

Style Drift

Score: 15

The process has risk controls built in with regard to sector weights and duration. Attribution analysis provided by BlackRock’s Aladdin system. Within the portfolio management team there is good separation of responsibilities as well as back-up and cross-checks. Further, trade settlement and back-office support is separate from portfolio management. Wilshire has reviewed and had input into the drafting of the procedures manual that covers portfolio management, trading operations systems operations, and monitoring.

### Resources (0-100)

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### SCORE:

### COMMENTS:

Research (Alpha Generation) (0-40)

Appropriate for Product Style  
Conducted Internally/Externally  
Quantitative/Qualitative  
Sufficient Databases and Models for  
Research  
How are Research Capabilities Enhanced

Structured research is conducted internally analyzing the underlying securities with regards to quality and risk of prepayment.

Additional internal research could be performed by expanding Staff. This additional research could then be used in conjunction with the external research to help provide more robust analysis.

Score: 30

Information/Systems Management (0-15)

Ability to Manage Large Flows of Data  
Appropriate Systems for Research and  
Management

Hardware and software support is very strong. Members of Staff all have access to Bloomberg for research and information on current market conditions. Trading and portfolio management tools were custom-designed to CalPERS' specifications by a leading external vendor.

Score: 15

Marketing/Administration/Client Service (0-15)

Dedicated and Knowledgeable Group  
Quality of Materials/Presentations of RFPs  
Responsiveness  
Measuring Client Satisfaction

Since marketing and client service are not involved, unlike external sources for such a strategy, the full resources of staff will be devoted to CalPERS, as the portfolio managers will not have to travel to service other clients or market to prospects.

End client (Investment Committee) has regular meetings that usually require SIO and Portfolio Manager, but team is able to continue to operate in their absence.

Score: 15

Trading (0-30)

Turnover Relative to Process  
Sophistication of Trading Process  
Measurement of Trading Costs

CalPERS' trading room is very sophisticated, was constructed in the last two years, and has subscriptions to all of the most popular trading resources, i.e. Bloomberg, Instinet, ITG, WM, etc. There is sufficient back-up and separation of responsibilities in the trading function. There is ex-post review of trading execution, but as with all trading reviews it can be improved.

Score: 25